

**STATEMENT OF J. RICHARD BERMAN  
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U. S. DEPARTMENT OF HOMELAND SECURITY  
BEFORE THE  
SELECT COMMITTEE ON HOMELAND SECURITY  
U. S. HOUSE OF REPRESENTATIVES  
OCTOBER 8, 2003**

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to be here today to discuss financial management and program evaluation at the Department of Homeland Security (DHS).

On March 1, 2003, DHS was created by consolidating 22 disparate domestic agencies to better protect the nation against threats to the homeland. In order for DHS to accomplish its multiple missions, it has organized most of these 22 agencies into four major directorates. The Border and Transportation Security Directorate, which maintains the security of our nations' borders and transportation systems, is the largest and consists of several legacy agencies, including the Transportation Security Administration (TSA), the U.S. Customs Service, the Office of Domestic Preparedness (ODP), and law enforcement functions, such as the Border Patrol, of the Immigration and Naturalization Service (INS). The Emergency Preparedness and Response Directorate is primarily the former Federal Emergency and Management Agency (FEMA), and ensures that our nation is able to recover from terrorist attacks and natural disasters.

Smaller agencies were incorporated into the above directorates as well as into the Science and Technology and Information Analysis and Infrastructure Protection Directorates. Additionally, the Coast Guard and Secret Service retained their distinct identities within DHS. The newly created Bureau of Citizenship and Immigration Services will assume the responsibility for immigration services from the former INS. Providing the infrastructure to hold the department together is the Management Directorate, which is responsible for budget, management, and personnel activities.

Each of the component agencies brought to DHS its distinct business processes, which presents DHS with challenges in integrating operations, creating a common infrastructure, and developing goals, objectives and meaningful performance measures to guide and track progress. All of these challenges impact financial management at DHS.

Financial management in the federal government revolves around requirements found in several laws, including the Federal Managers Financial Integrity Act, the Chief Financial Officers Act, the Federal Financial Management Improvement Act (FMFIA), and the Government Performance and Results Act. Agencies must ensure that: (1) government obligations and costs are lawful; (2) funds, property, and other assets are safeguarded; (3) reliable, timely, and useful information is available to make fully informed decisions and to provide accountability; and (4) performance is measured.

Following is an overview of the major financial management challenges facing DHS, along with the steps we believe are needed to address these challenges and establish sound financial management and business processes at DHS. We also provide substantive comments on H.R. 2886, *The Department of Homeland Security Financial*

*Accountability Act*, including the amended version offered by the Subcommittee on Government Efficiency and Financial Management.

## **OVERVIEW OF FINANCIAL MANAGEMENT CHALLENGES AND SOLUTIONS**

### **Financial Systems and Reporting**

DHS must integrate and establish effective controls over the financial systems and operations of the incoming components, many of which bring with them longstanding weaknesses in need of correction. DHS inherited a total of 18 material weaknesses identified in prior year financial statement audits at the legacy agencies. I have included a list and brief description of these weaknesses as an appendix to my statement. We will be assessing these material weaknesses, and the need to retain or add to them, as part of our FY 2003 financial statement audit.

Correcting such weaknesses presents a major challenge. For example, some components, such as INS<sup>1</sup>, have received unqualified audit opinions on their financial statements, but expended tremendous human resources and costs to prepare their financial statements, and weaknesses existed in financial systems and controls. In the past, INS has halted normal business operations for up to two weeks each year in order to conduct manual counts of millions of applications in order to calculate earned revenue figures for its annual financial statements. Poor systems were a major cause of these costly efforts.

While combining the 22 entities and their myriad financial systems and processes pose complex challenges, opportunities abound to achieve greater economy and efficiency. Information systems are a key issue that DHS must address in order to establish sound financial management and business processes. Many of the smaller agencies that came into DHS are still supported by their legacy agency systems and will need to migrate to a DHS platform. The larger agencies brought their own processing capability, but several of these systems have material weaknesses involving system functionality and security. Overall, DHS reports over 80 financial management systems, few of which are integrated.

To meet these challenges, DHS will need to build a unified financial management structure, including integrated and compliant systems as well as consistent policies and procedures. These systems must support not only efficient financial statement preparation; they must provide reliable and timely financial information for managing DHS' current operations, too. A key factor will be the sustained commitment of top DHS leadership, which the Chief Financial Officer (CFO) already has demonstrated. The CFO meets regularly with financial officers and staff from DHS components and legacy agencies that still provide accounting support to discuss the continuing transition and

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<sup>1</sup>Within DHS, INS has been broken apart and joined with the Bureau of Customs and Border Protection and the Bureau of Immigration and Customs Enforcement. Another part formed the Bureau for Citizenship and Immigration Services.

current DHS-wide financial management issues. Further, the CFO has formed a group to develop financial system requirements for the agency in coordination with the Office of the Chief Information Officer.

### **Grants Management**

DHS awards over \$7 billion annually in grants under its emergency preparedness and disaster assistance grants programs.

DHS absorbed three major emergency preparedness grant programs from FEMA and the Department of Justice (DOJ): the First Responder Program - \$3.2 billion; the Assistance to Firefighters Grant Program - \$750 million; and the Emergency Management Performance Grant Program - \$165 million. DHS also absorbed about \$450 million in miscellaneous emergency preparedness grant programs. Previous FEMA and DOJ Office of Inspector General (OIG) reports identified significant shortcomings in the pre-award process, cash management, monitoring, and grant closeout processes. Each of these programs has redundant or similar features such as emergency planning, training, and equipment purchases and upgrades for state and local emergency personnel. Furthermore, program managers need to develop meaningful performance measures related to the degree to which the DHS grant programs have enhanced state and local capabilities to respond to terrorist attacks and natural disasters.

Another complication is that these programs have been divided between two separate DHS directorates. Preparedness for terrorism was placed in the Border and Transportation Security Directorate, while other preparedness efforts are located in the Emergency Preparedness and Response Directorate. This bifurcation creates additional challenges related to inter-departmental coordination, performance accountability, and fiscal accountability. On September 2, however, DHS Secretary Ridge announced that soon he will be sending to Congress a plan centralizing these programs within a single office.

Additionally, DHS absorbed about \$2.8 billion in disaster assistance grant programs from FEMA. FEMA's OIG found that it had ineffective performance and financial oversight for these grants, which in turn enabled grant recipients and subgrantees to misuse millions of dollars in federal funds. Grant recipients' problems with financial management, procurement, and sub grant monitoring are long standing. Between 1993 and 2000, for example, auditors questioned the use of funds totaling nearly \$900 million dollars. An assessment of mitigation grants awarded between 1989 and 1998 disclosed that half of the \$2.6 billion in grant awards was never spent.

FEMA's OIG found recurring grant management problems at the state level, too. Often states did not monitor or accurately report on sub grant financial and performance activities. They did not always make payments or close out projects in a timely manner. Their financial status reports to FEMA were often incorrect or past due. And, they did not always maintain adequate documentation supporting their share of disaster costs and other financial requirements. The OIG found that FEMA seldom used its enforcement

power to compel grantees to fix problems, even when the grantees had long histories of noncompliance. Finally, the OIG cited FEMA's debris removal program for its susceptibility to serious fraud, waste, and abuse.

A sound grants management program to remedy these concerns must include:

- A comprehensive grants management system that complies with grant financial systems requirements issued by the Joint Financial Management Improvement Program. In addition, DHS must ensure compliance with the Federal Financial Assistance Management Improvement Act of 1999, which requires use of electronic application and reporting by grantees via the Internet.
- Effective monitoring of and assistance to states and other grantees in all phases of the grants management life cycle from award to closeout. Grant closeouts and required audits should be within established time periods, and extensions must be adequately justified, approved, and documented.
- Adequate training and supervision of the grants management workforce.
- Meaningful performance goals and measures of effectiveness.

### **Contract Management**

DHS also absorbed billions of dollars in contracts from the component agencies that were awarded under differing procedures and circumstances. DHS must integrate the procurement functions of several legacy agencies, some lacking important management controls. The General Accounting Office (GAO), for example, reported that Customs had not established process controls for determining whether acquired software products and services satisfied contract requirements before acceptance, nor established related controls for effective and efficient transfer of acquired software products to the support organization responsible for software maintenance. At TSA, where contracts totaled \$8.5 billion at the end of calendar year 2002, the Department of Transportation OIG found that procurements were made in an environment where there was no pre-existing infrastructure for overseeing contracts. TSA had to rely extensively on contractors to support its mission, leading to tremendous growth in contract costs. A review by TSA of one subcontractor involved with hiring airport screeners found that, out of \$18 million in expenses, between \$6 million and \$9 million appeared to be attributed to wasteful and abusive spending practices. Our office is currently reviewing several of the TSA contracts including a detailed audit of the screener contract, in conjunction with the Defense Contract Audit Agency.

Also, some DHS components have large, complex, high-cost procurement programs under way that need to be closely managed. For example, Customs' Automated Commercial Environment project will cost \$5 billion, and Coast Guard's Deepwater Capability Replacement Project will cost \$17 billion and take more than twenty years to

complete. Further, some contracts, regardless of their earlier merits, may need to be revised or may no longer be necessary to accomplish DHS's mission.

Early attention to strong systems and controls for acquisition and related business processes will be critical both to ensuring success and maintaining integrity and accountability. Steps would include:

- Establishing an overall acquisition strategy for modernization of legacy program and financial systems.
- Reviewing all contracts transferring to DHS to ensure they are relevant to the agency's mission and - particularly for systems development contracts - will not be affected by, or conflict with, DHS system integration efforts.
- Ensuring that contracting officers and their representatives are properly warranted, trained, and supervised, and that they maintain proper documentation in contract files.
- Establishing a robust and effective contract management and oversight function.
- Establishing effective systems and controls for managing purchase and travel cards.

### **Improper Payments**

The Improper Payments Information Act of 2002 requires agencies to review all programs and activities they administer annually and identify those that may be susceptible to significant erroneous payments. Where the risk of erroneous payments is significant, agencies are to estimate the annual amount of erroneous payments and report the estimates to the President and Congress with a progress report on actions to reduce erroneous payments.

Since DHS must comply with this Act in FY 2004, we will be performing limited procedures during the FY 2003 financial statement audit to assess the agency's readiness to meet the reporting requirement.

### **Performance Reporting/Program Analysis and Evaluation**

Appropriate plans (including workforce plans), goals, objectives and meaningful performance measures must be established as soon as possible, and is a challenge for any agency. DHS has implemented a comprehensive Measures of Effectiveness project under which such measures will be established through a top-down process based on the DHS strategic goals. We commend the agency for this effort.

Measures of effectiveness are critical to the process of evaluating the degree of success of department programs and operations, and making more informed resource allocations and

budget decisions. OIG will use the department's goals, as well as the President's management initiatives, in shaping its own work plans and priorities, and will verify and validate the department's performance data as part of its audits and inspections.

## COMMENTS ON H.R. 2886

### **Presidential Appointment and Senate Confirmation of DHS CFO**

H.R. 2886 would amend U.S.C. 31 to include DHS as one of the cabinet level agencies required to have CFOs appointed by the president and confirmed by the Senate. As a result of this amendment, the DHS CFO would also report directly to the Secretary of DHS rather than to the Under Secretary for Management, as is now the case.

The OIG has no position on this change. As a general rule, we believe that making high-level presidential appointees subject to Senate confirmation is conducive to making such an official fully accountable to the Administration and the Congress. On the other hand, the absence of such confirmation does not necessarily mean that the CFO can-not be held accountable. Our primary interest is that the CFO commit to full compliance with the CFO Act, the Federal Financial Management Improvement Act, and all other applicable statutory requirements and general good business practices, and this CFO has done that.

### **Financial Statement Waiver**

H.R. 2886 waived the requirement for a financial statement audit of DHS until FY 2004. The amended version deleted this language, a change that the OIG supported. Completion of a FY 2003 financial statement audit for DHS is important for several reasons. Effective in FY 2004, OMB accelerated the reporting deadlines for Performance and Accountability reports, including audited financial statements, to November 15, 2004. It is unlikely that our office could complete its FY 2004 audit of DHS' financial statements by that date, without at least one year's prior experience, given the short history of DHS and the scale and complexity of its programs and operations. Further, the lack of an audit this year and possible audit timing problems next year could negatively affect GAO's government-wide financial statement audit by increasing the risk of DHS receiving a disclaimer or a qualified opinion.

We believe emphatically that financial accountability for DHS should not be postponed. Its newness, size, and complexity strongly argue for more oversight, not less. GAO has designated the establishment and operation of DHS as a "high-risk" area. An audit of DHS' financial statements is a key oversight mechanism. Not only do audited financial statements provide insight into the reliability of financial reporting, the audit report itself provides details on internal control weaknesses and non-compliance that put financial reporting and safekeeping of assets at risk. We strongly believe that this information should be reported sooner rather than later so that no time is lost in charting and implementing corrective actions.

The CFO of DHS is working diligently to have auditable financial statements for FY 2003 by November 15. Our audit is well underway and we plan to complete the audit by January 31, 2004.

### **Opinion on Internal Controls over Financial Reporting**

H.R. 2886 required that beginning in FY 2004 DHS include in its performance and accountability report an audit opinion on the department's internal controls over its financial reporting. The amended version requires DHS to include management's assertion on internal controls in the FY 2004 report but defers the audit opinion on internal controls until FY 2005.

The OIG believes that a requirement for an opinion on internal controls would be beneficial in concept, but it is not practical to render an opinion on internal controls in FY 2004 for several reasons. Deferral of this requirement to FY 2005 would allow time for the related auditing standards and procedures, and the related costs, to be more properly considered.

Fundamental to rendering an opinion on internal control, under attestation standards currently proposed by the American Institute of Certified Public Accountants (AICPA), is "management's assertion" on controls over financial reporting. Management must provide the auditor an assertion that significant controls over financial reporting exist and are designed and operating effectively during the period under review. In order for management to reasonably make this assertion, it must make an assessment of those controls including an evaluation of control effectiveness using suitable criteria, such as the GAO's *Standards for Internal Control in the Federal Government*, and support the evaluation with sufficient evidence such as testing. Management's assessment of internal controls under the AICPA guidelines would be an extensive, time consuming process requiring sufficient lead time to institute. The need for management to first assess and test controls contributed to a one year deferral of the requirement for publicly held companies to have an independent audit of internal control, pursuant to the Sarbanes-Oxley Act of 2002.

Further, DHS's situation is significantly more complex, with its inception occurring this year, compared to that of a publicly held company that has established processes, financial systems, and the general infrastructure to support the extensive effort required before an audit of internal controls can be performed.

Finally, with the advent of Sarbanes-Oxley, changes are occurring in the auditing profession. Although Sarbanes-Oxley applies only to public companies, it could have an impact on auditing standards for other entities too, including government agencies. The Auditing Standards Board (ASB) of the AICPA in June 2003 submitted to the new Public Company Accounting Oversight Board (PCOAB)<sup>2</sup> its recommended new, significantly expanded attestation standard for reporting on internal control over financial reporting.

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<sup>2</sup> The PCOAB has jurisdiction over auditing standards for public companies covered by Sarbanes-Oxley.



In the submission letter, the AICPA said it believed the proposed standard should apply to all engagements and not just to public companies.

It should be noted that the intent behind the requirement to opine on internal controls over financial reporting is similar to the intent behind FMFIA, although FMFIA has involved a far less rigorous process. Consideration should be given to combining these requirements when deliberating the proposed internal control reporting requirements.

Even without an opinion on internal controls, our financial statement audit report will identify material weaknesses and other reportable conditions related to financial reporting. For example, DHS financial statement auditors for FY 2003 will consider internal controls related to financial reporting for grants, procurement, property and equipment, inventory, budgetary reporting, liabilities, and many other categories.

We believe there would be significant additional cost to render an opinion on internal controls. The size of this increment would depend on the extent of evaluation and testing performed by DHS and the audit approach for the financial statements. In the private sector, one survey found that the cost of complying with the internal control reporting requirements of Sarbanes-Oxley would increase the average audit cost by 35 percent. This might be on the low-end for DHS because of its newness and complexity. Further, there will likely be significant costs associated with management's assessment of internal controls, which, as explained above, would be a prerequisite for the audit.

We believe that rendering opinions on internal controls over financial reporting at agencies could be beneficial by identifying additional weaknesses, and focusing attention on the state of financial management in the government. The terminology of a clean opinion versus a qualified opinion or disclaimer provides a ranking system that is easy to grasp. The downside is the additional cost to fund agency preparations and the audit itself.

### **Study of Potential Costs and Benefits of Audit Opinions on Internal Control**

The amended version of H.R. 2886 requires that the CFO Council and the President's Council on Integrity and Efficiency jointly conduct a study of the potential costs and benefits of requiring agencies to obtain audit opinions of internal controls over their financial reporting. We endorse this provision.

We believe the costs, as discussed above, could be substantial. Therefore, it is worth examining the issue to ensure that the most efficient and effective audit procedures can be adopted and that the costs are in line with the benefits. We assume the study will include such an examination.

## **CONCLUSION**

Mr. Chairman, this concludes my prepared statement. I have tried to limit my remarks to the areas of greatest concern and your specific questions. Please be assured that our office will continue to place a high priority on these issues. Again, I appreciate your time and attention and welcome any questions you or members of the Committee might have.